Executive Summary

Founded in 1929, the Seattle City Employees' Retirement System (SCERS) has provided comfortable retirements to several generations of City workers. It is a defined benefit pension plan for general government employees that grants 2% of salary in retirement for each year of City service. In this way, an employee who works for 30 years may retire with a 60% pension that is guaranteed for life. The plan is designed to work in conjunction with Social Security, so that a member's total retirement income is the sum of the two benefits, plus whatever private savings he or she has accumulated. Together, these sources are projected to replace between 87% and 109% of working income in retirement. By standard retirement planning measures, this is considered more than adequate to maintain employees' standard of living once they leave work.

SCERS entered 2008 with 92% of its required funding, which is considered a relatively healthy level. The plan is funded by City and employee contributions each pay period, plus earnings on SCERS' $1.8 billion investment portfolio. SCERS was significantly impacted by the market crises of 2008, a year in which the plan booked a $616 million investment loss that erased 30% of its funding ratio. The portfolio has still not returned to its pre-2008 value even as costs have grown. As a result, the City and its employees must pay higher contribution rates to cover the system's approximately $1 billion in unfunded costs over the next 30 years. And this liability could grow if the plan's investments continue to lag their 7.75% annual return target, which they are currently projected to do for at least the next 10 years. In this context, the Seattle City Council asked staff to form an Interdepartmental Team (IDT) and look at potential changes to the pension system for new hires. The goal was to design a system that still provides ample retirement income but at lower cost for both the City and employees. The Council appropriated $250,000 for consulting resources for this effort, and in 2011, the Legislative Department hired the national actuarial firm Gabriel, Roeder, Smith & Company to advise the IDT on plan design and to perform cost estimates.

Financial Findings

Over the last 40 years, the City and its employees have nearly doubled the share of payroll that goes to the retirement benefit, from 12% in 1972 to nearly 24% projected for 2014. In dollar terms, this means the City and employees will spend about $64 million more annually to fund employee retirements than they would have at the old rate. These costs are borne by the City's General Fund and its other operating funds, including Seattle Public Utilities and Seattle City Light. Several factors have driven this rise:

- <u>Investment losses in 2008</u> meant that the system has lost 30% of its funding and must replace approximately $1 billion over time. It is unlikely that even strong investment returns could make up this lost value without substantial additional contributions.

- <u>The City increased benefits</u> in 1975, 1998 and again in 2001, the latter two changes happening at a time of strong stock market performance when the system was briefly at or above 100% funding. These benefit changes permanently increased the cost level.

- <u>Employees are living longer</u>. Although this is a good thing, increased longevity raises retirement costs, since SCERS must pay the guaranteed benefit over more years.

SCERS Compared to Other Retirement Plans: *High Benefit and High Cost*

Private sector employers since about 1978 have largely abandoned the defined benefit pension model in favor of defined contribution plans, such as the 401(k) plan. These carry no benefit guarantee but allow employees to invest their own contributions (and often an employer match) in portable individual accounts. Most employers with defined contribution plans provide a maximum match worth between 3% and 6% of salary.

Public sector employers (including states, cities, counties, and school districts) generally still provide defined benefit plans, but their benefits are less rich on average than Seattle's SCERS benefit.

- Seattle's 2.0% benefit multiplier is higher than the 1.85% average for public plans with Social Security. This translates to a 30-year pension that is about 5% higher (60% of salary vs. 55%).

- Seattle's normal retirement ages are also younger than the average for public plans. Normal retirement is the age at which a member may begin benefits without any reduction for early retirement. Many SCERS members may retire with full benefits while still in their 50s. Most public plans have now moved to 60 or 65 as a normal retirement age.

- SCERS' benefit table also subsidizes early retirement. Benefits are reduced either 3% or 5% for each year early that a member retires. It takes a factor of about 7% to ensure that the plan's costs are not increased when a member retires early.

For this richer-than-average pension benefit, Seattle employees pay about twice as much as the average public sector employee. Seattle's current employee contributions are 10.03% of salary, compared to a national median rate of about 5%. So in general, the City and its employees are in a high-benefit, high-cost part of the spectrum.

State and local jurisdictions across the country have implemented pension changes in the wake of 2008 to lower their costs. Their approaches have included reducing benefits (either for new hires or for existing employees as well), suspending cost of living adjustments, increasing contributions, and enacting new limits on so-called "spiking" and "double dipping" practices. Several states have also recently closed their defined benefit plans and replaced them with defined contribution plans for new hires, or hybrid plans that mix the features of both.

Five Plan Options to Consider for New Hires

With the assistance of GRS, the team has crafted five retirement plan options for the City and its employees to consider. They include three plans that keep the current SCERS defined benefit (DB) structure, but adjust the benefit multiplier and normal retirement ages, among other provisions. The fourth plan is a hybrid, similar to the State of Washington's PERS 3 plan and the FERS system for federal employees. It features half-sized DB pension coupled with a defined contribution (DC) account that together provide similar amounts of retirement income. The final plan is a defined contribution plan, with mandatory contributions from the City and employees, similar to 401(k) plans found in the private sector.

All five plan designs presented in this report meet or exceed the test of providing adequate retirement income, defined as the level that will allow employees to maintain their standard of living. For example, for a middle-income employee with 30 years of service who retires at age 65, the plans are projected to provide between 80% and 92% of the member's previous income, in conjunction with Social Security. If the employee also has private savings (through the City's deferred compensation plan or a Traditional or Roth IRA) the replacement ratio would be even higher.

Table 1 – Summary of the Five Plan Options' Major Features and Normal Cost Savings
Normal cost is the amount needed to finance benefits that are earned today.
It does not include any unfunded costs of previously earned benefits.

Defined Benefit (DB) Provision	Current Plan	Modest Change DB #1	Modest Change DB #2	Substantial Change DB	Hybrid DB + DC	DC only
Multiplier: *Earned benefit per year of service*	2.0%	1.83%	2.0%	1.66%	1.0%	n/a
Maximum Years *to earn service credit*	30	33	30	36	35	
Maximum Pension *as a % of salary*	60%*	60.5%	60%	60%	35%	
Final Average Salary *calculation period (in months)*	24	36	36	36	36	
Normal Retirement Age *Lesser of 65, or when age + years of service equals rule*	Rule of 80	Rule of 85	Rule of 90	Rule of 90	Rule of 85	
Early Retirement Reduction *each year before normal age*	3% or 5%	7%	7%	7%	7%	
Normal Cost *Contribution as a % of salary*	15.0%	11.8%	11.5%	10.0%	6.4%	
Defined Contribution (DC) Provision *Contribution as a % of salary*	n/a				6.5%	12.0%

** May be higher under alternative minimum benefit annuity formula.*

Total Normal Cost *% of salary*	15.0%	11.8%	11.5%	10.0%	12.9%	12.0%
Savings Relative to Current Plan: *% of new hires' covered payroll*		3.2%	3.5%	5.0%	2.1%	3.0%
5-year savings (in millions)		$19	$20	$31	$15	$15
30-year savings (in millions)		$1,751	$1,863	$2,764	$1,123	$1,601

Income Replacement** *% of working income replaced by pension + Social Security*	94%	85%	90%	80%	82% to 92%	70% to 87%

** Middle-income earner with 30 years of service who takes Social Security at age 65 and has 6.25% to 7.75% average investment returns on the DC account.

The plans would save between 2.1% and 5.0% of covered payroll for new hires. At today's staffing levels, each 1% of covered payroll is worth about $5.6 million per year. However, these savings would accrue gradually over a generation as new employees enter the system. The actuaries project that adopting one of the new plans would reduce total pension costs between $15 million and $31 million in the first five years after implementation. It would save between $1.1 billion and $2.8 billion over 30 years. These savings will leave more money available in the City's budget for other pressing needs, including services to residents, new hiring, staff salaries, and potentially other employee benefits.

The plans each make different choices on how to share key risks, which may be as important a factor to consider as the current cost projections. This includes investment risk, which is the possibility that the investment returns will fall short of their targets and generate less money to support employees' retirements. Under the DB plans, the City bears this risk. The Hybrid plan shares it roughly equally between the City and the employees, and under the DC plan, the employees bear the risk.

The City may also wish to consider options for how it implements the plans presented here. In acting on this report, the City could:

- Join the State of Washington's open PERS 2 and/or PERS 3 plans instead of creating a new plan for Seattle. The Modest DB Plan #2 is very similar in design to PERS 2, and the Hybrid Plan is fairly similar to PERS 3. Opting in to the state's plan may lower costs and boost investment performance. It would also require a negotiation with the Legislature to address who pays the unfunded costs of the state's closed PERS 1 plan.

- Allow current employees to voluntarily opt in to one of the new plan designs in exchange for a lower contribution rate. This may appeal to some current employees who expect lengthy careers with the City and want to take home more of their paychecks in the meantime. The actuaries project rather low take-up rates on this offer, but it may accelerate the savings to the City somewhat.

- Offer two plan choices to new hires, a DB plan plus either a Hybrid or a DC option. This would be more complex and costly to administer but may aid recruitment and retention by appealing to prospective employees with different retirement preferences.

The IDT thanks the Mayor, the City Council, and the reader for the opportunity to present this work and hopes that the City and its employees will give it their careful consideration.